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In the Supreme Court of the United States

OCTOBER TERM, 1994

ARCHER-DANIELS-MIDLAND COMPANY, ET AL.,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

Whether the "no loss" rule contained in Treasury Regulations Section 1.994-1(e)(1)(i) properly implements Section 994 of the Internal Revenue Code, 26 U.S.C. 994.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 37 F.3d 321. The opinion of the district court (Pet. App. 9a-24a) is reported at 798 F. Supp. 505.

JURISDICTION

The judgment of the court of appeals was entered on October 3, 1994. A petition for rehearing was denied on November 2, 1994 (Pet. App. 25a-26a). The petition for a writ of certiorari was filed on January 25, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In March 1972, petitioner incorporated a wholly owned subsidiary (Ardanco, Inc.) to take advantage of the tax benefits provided for a domestic international sales corporation (DISC) by Sections 991 through 997 of the Internal Revenue Code.[1] The DISC provisions, which were added to the Internal Revenue Code by Section 501 of the Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 535-549, were adopted to encourage export sales of domestic products.[2] The DISC—which is ordinarily a corporate shell by or through which export sales are made—is not subject to tax. 26 U.S.C. 991. Instead, the DISC's shareholder is taxed directly on a specified percentage of the DISC's current income as if that amount had been distributed as a dividend at the end of the taxable year. 26 U.S.C. 995(a). The remainder of the DISC's income is not taxed until either (i) it is actually distributed, (ii) the shareholder disposes of its DISC stock or (iii) the DISC loses its special status. 26 U.S.C. 995(b) and (c). The larger the share of income attributed to the DISC, the larger the share of income tax that is deferred. This case concerns the calculation to be made under Section 994 of the Code of the amount of income to

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[1] Petitioner Archer-Daniels-Midland Company brought this tax claim on its own behalf and as common parent of an affiliated group of corporations, of which only Fleischman-Kurth Malting Company and Coeval, Incorporated were named as additional plaintiffs below. In this brief, we refer to the parent corporation as petitioner.

[2] As the court of appeals noted (Pet. App. 2a), in Sections 801-805 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 985-1003, Congress limited the DISC provisions and largely replaced them with the Foreign Sales Corporations provisions (26 U.S.C. 921-927).

be attributed to petitioner and its DISC, respectively, from the foreign sales transactions.

Section 994 provides three methods for attributing the combined taxable income from the export sale to the DISC and its related supplier (which is usually, as here, its parent shareholder corporation). That Section provides, in relevant part, that "the taxable income of such DISC and such [related supplier] shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale * * * in an amount which does not exceed the greatest of" (i) four percent of qualified export receipts on the sale of the property by the DISC (the "gross receipts" method), (ii) fifty percent of the actual combined taxable income on the sale of the property by the DISC (the "combined taxable income" method), or (iii) the taxable income that would result if the DISC purchased the item at a fair market price and resold it at the price actually charged (the "arm's length" method). 26 U.S.C. 994(a).[3]

The legislative history of Section 994(a) evidences that these methods of allocation of "income" should not be applied in a manner that would result in a "loss" being reflected on the account of the related person who sold the product to the DISC (Pet. App. 5a). A "loss" for these purposes would result, for example, if the "income" allocated to the DISC under the gross receipts method were to exceed the actual combined "income" of the DISC and its related supplier from the sale of the export property (*ibid.*).

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[3] When, as was sometimes true in this case, export sales are made by the DISC on a commission basis, the taxable income of the DISC is to be determined pursuant to regulations prescribed by the Secretary consistent with the rules set forth in Section 994(a). See 26 U.S.C. 994(b)(1).

Treasury Regulations Section 1.994-1 incorporates that "no loss" interpretation of the statute. The Regulation provides that "neither the gross receipts method nor the combined taxable income method may be applied to cause in any taxable year a loss to the related supplier" and that "[a] loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC." 26 C.F.R. 1.994-1(e)(1)(i). Under the Regulation, the maximum amount of taxable income that may thus be allocated to a DISC is an amount equal to the entire actual taxable income realized by the DISC and its related supplier from the export sale.

2. Petitioner selected the gross receipts method to compute its DISC's taxable income. In filing its original tax returns, petitioner allocated the entire combined taxable income from the export sales to the DISC. Petitioner thereafter filed claims for refund contending that Section 994(a) creates a mathematical formula for "establishing" the taxable income of the DISC, even though the amount so "established" was greater than the combined taxable income earned on the export sale. According to petitioner, taxable income can be "established" in its DISC—in an amount equal to four percent of the qualified export receipts from the sale of export property—without regard to the actual combined taxable income attributable to the sale (Pet. 16). Petitioner thus contended that Treasury Regulations Section 1.994-1(e)(1)(i) was invalid and that, for the taxable years in issue, petitioner was entitled to "establish" total taxable income of $147,292,717 in the DISC—an amount equal to four percent of the gross foreign sales—even though the actual combined taxable

income from those sales was only $57,197,346 (Doc. 25, PXs J-1 through J-4; Doc. 34, Stip. Exh. D).[4]

3. The district court accepted petitioner's contention. The court concluded that the language of Section 994(a)(1) unambiguously permits a taxpayer to establish taxable income in a DISC in an amount equal to four percent of qualified export sales, without regard to the fact that the result of such an artificial attribution would be to create a loss for the DISC's related supplier. Since the court found the statute unambiguous, it refused to consider the relevant legislative history (Pet. App. 9a-24a).

4. The court of appeals reversed. The court noted that, under the district court's interpretation, "even if the combined income of the DISC and its owner is zero or even negative, the owner can still shift income equal to 4 percent of its export sales to the DISC—provided that it has income elsewhere in its business, for otherwise the maneuver would confer no benefit on it" (Pet. App. 3a). The effect of petitioner's interpretation of the statute would be "to obtain favorable tax treatment for * * * its domestic income" as well as its foreign sales income (*id.* at 4a). The court rejected petitioner's contention that this interpretation was compelled by the language of the statute (*id.* at 4a-5a):

> It is not compelled. The exporter is allowed to fix a transfer price that will allow its "DISC to derive

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[4] In the amended Form 1120 DISC returns filed for Ardanco for the years in question, Ardanco claimed taxable income of $147,292,717, or $90,095,371 more than the actual combined taxable income of $57,197,346 on the export sales. At the same time, petitioner and other related suppliers claimed reciprocal deductions totalling $147,292,717, resulting in a claimed *loss* from the sales of $90,095,371 (Doc. 25, PXs J-1 through J-4; Doc. 34, Stip. Exh. D).

> taxable income *attributable* to [the export] sale," 26 U.S.C. § 994(a), and in our hypothetical sale [petitioner] has no income from its export sales. To read section 994(a) as implying that the 4-percent-of-gross-receipts method of calculating DISC income in subsection (1) is capped at the amount of taxable income derived from export sales is not inevitable, but it is plausible, and it is supported by the legislative history. Both committee reports describe the 4 percent of gross receipts method as a way of calculating a ceiling on gross income. H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 107 (1971).

The court noted that petitioner's interpretation of Section 994(a)(1) would have "potentially far-reaching effects * * * such as encouraging purely domestic businesses to acquire export subsidiaries as tax shelters" (Pet. App. 5a). The court concluded that, while "[t]he statute could be clearer * * * it adequately supports the Treasury's regulation, to which we are supposed to accord a certain amount of deference" (*id.* at 6a, citing *Cottage Savings Ass'n* v. *Commissioner*, 499 U.S. 554, 560-561 (1991), and *Gehl Co.* v. *Commissioner*, 795 F.2d 1324, 1328-1329 (7th Cir. 1986)).

Judge Hill, in dissent, agreed with the district court in concluding that the regulation was contrary to the statute (Pet. App. 7a-8a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. As petitioner concedes, due to the significant changes made to the foreign sales provisions of the Code in 1984, it is "unlikely that the construction

of this particular language is of enduring significance" (Pet. 7).[5] Further review is therefore not warranted.

1. Petitioner asserts that "the court of appeals erred in two * * * respects": (i) by allegedly carving out "a new and unwarranted exception to the proposition that the plain language of a statute should control" and (ii) by allegedly adopting "an approach that guts the basic proposition that the plain language of a statute should govern" (Pet. 8). Both alleged errors are predicated upon the contention that the court of appeals improperly resorted to legislative history to override the "plain language" of Section 994(a).

a. That contention misapprehends the logic and the language of the decision below. The court did not, as petitioner would have it, ignore or reject the "plain language" of the statute. Instead, the court considered two competing interpretations of that language and concluded that neither was "compelled" by the words of the statute itself (Pet. App. 4a-5a). It was in that context that the court noted that the legislative history clearly

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[5] As petitioner points out (Pet. 7), the DISC provisions were replaced by different provisions governing "Foreign Sales Corporations." 26 U.S.C. 921-927. See also note 2, *supra*. These provisions are similar to the DISC provisions (see generally S. Prt. No. 169, 98th Cong., 2d Sess. 630-661 (1984); H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 968-977 (1984)) and, in particular, they employ a "percent of the foreign trading gross receipts" concept that is analogous to the gross receipts method of Section 994(a)(1). See 26 U.S.C. 925(a)(1). The same "no loss" provision found in the regulation involved in this case is also carried forward for foreign sales corporations in Treasury Regulations Section 1.925(a)-1T(e)(1). But, as petitioner notes (Pet. 7), the specific limits placed on the gross receipts method of allocating income for foreign sales corporations by Section 925(d) limit the practical importance of the decision in this case in the foreign sales corporation context. See 26 U.S.C. 925(d).

supports the no-loss interpretation of the statute (*id.* at 5a, citing H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 107 (1971)) and that the Treasury's consistent interpretation is entitled to "a certain amount of deference" (Pet. App. 6a).

Neither of those standard propositions is exceptional. Indeed, petitioner does not purport to make either of them the basis for its request for further review. Instead, petititoner seeks review of a different determination—to ignore statutory language and rely on legislative history instead—that the court of appeals did *not* make in this case.

b. The court of appeals correctly explained why the language of the statute supports the "no loss" rule (Pet. App. 5a). The statute permits an exporter to fix a transfer price that will allow the DISC "to derive taxable income *attributable* to [the export] sale" in an amount that may not "exceed" the greater of four percent of sales revenue, fifty percent of the combined income from the sale, or the income resulting from an imputed arm's length price. 26 U.S.C. 994(a)(1)-(3) (emphasis added). To suggest, as petitioner does, that an amount of income *in excess of* the taxable income generated by an export sale is nonetheless *attributable* to the export sale is nothing more than an invitation to ignore the plain language of the statute. The court of appeals quite properly rejected petitioner's invitation and chose instead to give heed to the words of the statute itself.

It is evident that the statute does not, as petitioner contends, guarantee the DISC an attributed income of four percent of the foreign sales revenues. Petitioner's contention is premised on its insistence that the statute "speaks * * * of establishing the DISC's income by attributing (not 'allocating') to the DISC 4 percent of

[petitioner's] export *receipts* without reference to [petitioner's] export income" (Pet. 16). But Section 994(a) allows a DISC to derive taxable income attributable to an export sale "in an amount which does not exceed" the greater of four percent of export receipts, fifty percent of combined taxable income resulting from the sale, or the income resulting from an imputed arm's length price. 26 U.S.C. 994(a)(1)-(3). The statute thus establishes four percent of gross sales as a *maximum*, not a minimum, for allocation. The "income" from the transaction that is to be allocated to the DISC may "not exceed" that percent; it need not equal it. It is petitioner's interpretation, not the interpretation adopted by the Treasury and by the court of appeals, that departs from the plain language of the statute.

c. The fact that the court of appeals found support in the relevant committee reports for an interpretation of the statutory language that differs from the interpretation advanced by petitioner is no basis on which to overturn the decision of the court of appeals. We know of no decision of this Court or of any court of appeals (and petitioner cites none) holding that it is error to adopt an interpretation of a statute that is consistent with its legislative history.[6] On the contrary, and as petitioner concedes, "legislative history can play an important role in statutory construction" (Pet. 9). It is not a novel proposition that the legislative history of a statute may shed light upon the intended meaning of statutory language that can support more than one interpretation. See, *e.g.*, *Atkins* v. *Parker*, 472 U.S. 115, 124-126 (1985).

2. Petitioner further contends that "[e]ven assuming that the phrase 'derive taxable income attributable to

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[6] Petitioner concedes that "this is the rare case where there is no conflict in the legislative history" (Pet. 17).

[the export] sale' could, in isolation, be read as imposing a no-loss limitation, the structure of the statute precludes such an interpretation here" (Pet. 14). The "structure of the statute" to which petitioner refers is the third of the three attribution methodologies—the income resulting from an imputed arm's length price—which petitioner asserts is not subject to an express "no-loss" rule.

The no-loss rule does not mean, as petitioner implies, that if an actual loss results from the transaction the related supplier would not be permitted to recognize its loss. Instead, the "no-loss" rule means that a loss may not be artificially created for the parent by attributing income to the DISC in excess of the income "attributable to the sale" (26 U.S.C. 994(a)). The regulation states that the attribution methods may not (26 C.F.R. 1.994-1(e)(1)(i)):

> be applied to cause in any taxable year a loss to the related supplier, but either method may be applied to the extent it does not cause a loss. A loss to a related supplier would result if the taxable income of the DISC would exceed the combined taxable income of the related supplier and the DISC. If, however, there is no combined taxable income of the DISC and the related supplier (because, for example, a combined loss is incurred), a transfer price * * * will not be deemed to cause a loss to the related supplier if it allows the DISC to recover an amount not in excess of its costs (if any).

Petitioner errs in contending that there is an inconsistency in not separately specifying that this "no loss" rule is applicable to the third attribution method—the "arm's length" method of Section 994(a)(3). Unlike the fictional, percentage attribution of income con-

templated by subsections (a)(1) and (a)(2), the attribution of income under (a)(3) is on the basis of a market price valuation of the transaction. In this fashion, the statute directly assures that only the income "attributable to [the export] sale" may be assigned to the DISC. The "no-loss" rule performs precisely that same function when the income is attributed on a percentage of revenue or income basis rather than in the imputed arm's length manner. The "no loss" rule thus ensures that income allocated to a DISC under any of the three methods will be "taxable income attributable to [the export] sale" rather than income derived from domestic transactions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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